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Contract Law in Modern Commercial Transactions, an Artifact of Twentieth Century Business Life?

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Contract Law in Modern Commercial Transactions, An Artifact of Twentieth Century Business Life?

James J. White*

I. Introduction

Diligent first year law students study contract law with a passion previously reserved for romantic objects and religious idols. Their professors lead them in extensive and difficult intellectual explorations of the wilds of contract law. There are careful analyses of why damage recovery X will stimulate performance Y, why recovery A is appropriate to encourage the aggrieved party to return to the market, and so on and so forth. Lurking behind this year long analysis are several inarticulate hypotheses: that they make rational evaluations of the threat of legal sanctions; that they respond in other varied and subtle ways to the law's command. Contracting parties are presented as a microcosm surrounded by an impermeable membrane, a microcosm always in equilibrium and always responding to the rules and sanctions of contract doctrine. Of course persons in this microcosm violate their contractual obligations but those injured by the violation are appropriately recompensed by damages, or are protected by specific performance or other order of the court. Neither the passions of man nor the effects of fire, flood, war, the demands of the economy, the harsh pressures of depression, inflation, or shortage cross this membrane. The microcosm is free of such influences, governed not by the law of nature or economics but by the law of contract.

It is my contention that all the ideas expressed in the foregoing paragraph are at best misleading, that some are downright inaccurate. It is my thesis that contract law is a much less significant determinant of commercial behavior in complex transactions than the typical law student, contracts professor, or lawyer dares believe. This notion may still seem heretical, but I am hardly the first to observe it. In his celebrated piece, *Non-Contractual Relations in Business*,[1] Professor Macaulay of the University of Wisconsin made the point twenty years ago. Surely the legal realists of the 1920's, led by Llewellyn himself, and the writings of Professor Gilmore on the death of contracts suggest similar ideas.[2]

My contribution to this debate is to offer some empirical content concerning contract administration in the chemical industry during a

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1. 28 AM. SOC. REV. 55 (1963). *See* Macaulay, *The Use and Non-use of Contracts in the Manufacturing Industry,* 9 PRAC. LAW. 13 (1963).

2. *See* G. GILMORE, THE DEATH OF CONTRACT (1974); Llewellyn, *What Price Contract?—An Essay in Perspective,* 40 YALE L.J. 704 (1931).

time of shortage. By an examination of that contractual behavior I hope to demonstrate the variety of sirens who compete with law for the contracting parties' loyalty. I do that in a setting in which the parties' behavior was in violation of their contractual obligations and was often known to be so.

II. THE RESEARCH OUTLINE AND THE APPLICABLE LAW

In 1974 and 1975 there were widespread shortages and allocations in the chemical industry.[3] Through lawyers in the industry, I became aware many of them had been involved in establishing allocation schemes and in advising their clients of the legal obligations in dealing with new and old customers; contract and noncontract.[4]

To understand the actual administration of an allocation plan, I interviewed approximately thirty people at ten chemical and pharmaceutical companies during the summer of 1977. In each case I interviewed those responsible for selling various products; in approximately half the cases I also interviewed corporate buyers. In all cases I administered a questionnaire.[5] The questionnaire reveals some of my premises: that each company would have an allocation plan; that most plans would be in writing; that most would be essentially pro rata; but that there might be other non-pro rata aspects. I began with the naive hope that each of the chemical companies would have a written allocation plan, and that a comparison of those plans would present a clear picture of the trade practice in the industry. Thus, I naively believed I could define this legal responsibility under the law by a reference to the trade practice in at least one industry.

My search for the law as defined by the behavior of the actors was stimulated by the knowledge that the lessons from section 2-615 of the

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3. Mandatory wage and price controls, instituted in August 1971, remained in effect for the chemical industry until January 1973. Phase III, which began in January 1973 called for voluntary compliance with federal guidelines limiting average price increases to 1.5%. *Phase III: More Freedom to Manage,* 12 CHEMICAL WEEK 10 (1973).

Between December 1972 and March 1973, the cost of fuel and raw materials rose sharply. *Rampaging Costs Pose New Peril to CPI Earnings,* 12 CHEMICAL WEEK 19 (1973). Many commodities were in short supply; mandatory price controls on crude petroleum and refined petroleum products were reimposed in March 1973; a government allocation program gave low priority to petrochemical products. *Id.*

In October 1973, OPEC announced a 40% increase in crude oil prices; within weeks the Arab oil embargo began. *What the Oil Cutbacks Will Cost,* BUS. WEEK, October 27, 1973, at 30. The embargo led to cutbacks in production, increased exports to evade price restrictions, the use of barter and tolling the chemical industry.

The embargo was lifted in March 1974, but many chemical commodities remained in short supply. For the third quarter of 1974, the chemical price index was up 42% over the 1973 average. *Petrochemicals: Prices Up, Supplies Down,* 78 PURCHASING 11 (1975).

4. Beginning in 1974 I appeared as a lecturer on several occasions in the Practicing Law Institute Program entitled *Breach of Contract in a Shortage Economy*. The magnitude of lawyers' interest in *force majeure* and allocation questions was well demonstrated both by the number of lawyers enrolled in those programs and by the questions they raised.

5. *See* Appendix *infra*.

Uniform Commercial Code (Code), relevant statutory law, and the few cases decided under it were quite imprecise.[6] Section 2-615(b) is the basic statement of the allocation rules:

> Except so far as a seller may have assumed a greater obligation and subject to the preceding section on substituted performance:
>
> . . . .
>
> (b) Where the causes mentioned in paragraph (a) affect only a part of the seller's capacity to perform, he must allocate production and deliveries among his customers but may at his option include regular customers not then under contract as well as his own requirements for further manufacture. He may so allocate in any manner which is fair and reasonable.

One gleans a certain set of rules from the Comment[7] and the statute. First, an allocation system need only be "fair and reasonable." It need not be strictly pro rata. It appears that a pro rata distribution scheme is one contemplated by the drafters as the most frequently appropriate one. That conclusion is strengthened by a study of the pre-Code and post-Code cases.[8] The Comment does state a series of for-

6. The majority of cases decided under U.C.C. § 2-615 considered commercial impracticability. Only a handful have addressed the allocation issue. *See* Harvey v. Fearless Farris Wholesale, Inc., 589 F.2d 451 (9th Cir. 1979) (customer with unenforceable contract cannot insist on allocation); Cecil Corley Motor Co., Inc. v. General Motors Corp., 380 F. Supp. 819 (M.D. Tenn. 1974) (plaintiff failed to establish it had placed orders for cars which G.M.'s Pontiac division had not filled); Intermar, Inc. v. Atlantic Richfield Co., 364 F. Supp. 83 (E.D. Pa. 1973) (court refused to enjoin defendant from limiting plaintiff to 104% of gasoline supplied one year earlier in comparable calendar month); Terry v. Atlantic Richfield Co., 72 Cal. App. 3d 962, 140 Cal. Rptr. 510 (1977) (affirmance of summary judgment for defendant supplier); Mansfield Propane Gas Co. v. Folger Gas Co., 231 Ga. 868, 204 S.E.2d 625 (1974) (trial court had held supplier must provide full delivery to contract customers, appellate court insisted on fair and reasonable allocation, presumably among contract and noncontract customers); Campbell v. Hostetler Farms, Inc., 380 A.2d 463 (Pa. Super Ct. 1977) (wet weather which prohibited planting full acreage excused seller's failure to deliver contracted for quantity; seller's retention of about 1/6 of yield to feed his stock was a reasonable allocation). *See also* White, *Allocation of Scarce Goods Under Section 2-615 of the Uniform Commercial Code: A Comparison of Some Rival Models,* 12 U. MICH. J.L. REF. 503 (1979).

7. Comment 11 expands on the rules set out in U.C.C. § 2-615(b) as follows:

> An excused seller must fulfill his contract to the extent which the supervening contingency permits, and if the situation is such that his customers are generally affected he must take account of all in supplying one. Subsections (a) and (b), therefore, explicitly permit in any proration a fair and reasonable attention to the needs of regular customers who are probably relying on spot orders for supplies. Customers at different stages of the manufacturing process may be fairly treated by including the seller's manufacturing requirements. A fortiori, the seller may also take account of contracts later in date than the one in question. The fact that such spot orders may be closed at an advanced price causes no difficulty, since any allocation which exceeds normal past requirements will not be reasonable. However, good faith requires, when prices have advanced, that the seller exercise real care in making his allocations, and in case of doubt his contract customers should be favored and supplies prorated evenly among them regardless of price. Save for the extra care thus required by changes in the market, this section seeks to leave every reasonable business leeway to the seller.

U.C.C. § 2-615, Comment 11 (1972).

8. For pre-Code cases, *see* Haley v. Van Lierop, 64 F. Supp. 114 (W.D. Mich.), *aff'd*, 153 F.2d 212 (6th Cir. 1945) (pro rata allocation doctrine applied in sale of flowers); Consolidation Coal Co. v. Peninsular Portland Cement Co., 272 F. 625 (6th Cir. 1921) (pro rata doctrine applied when shortage of coal cars inhibits shipment); Acme Manufacturing Co. v. Arminius Chemical Co., 264 F. 27 (4th Cir. 1920) (court accepted proration doctrine but found seller had diverted its sulphur supply to higher-priced non-contract uses); Luhrig Coal Co. v. Jones & Adams Co., 141 F. 617 (6th Cir. 1905) (proration doctrine applied in shortage of coal cars); McKeefrey v. Connells-

bidden acts. The seller may receive a higher price from his spot customers than from his contract customers, but he may not make an allocation which "exceeds normal past requirements. . . ."[9] It is implicit in the statement that he may not add new customers although no such prohibition is stated. The next to the last sentence forbids the seller from favoring one buyer over another because the favored buyer offers a higher price or other rewards. It is my contention that these rules of law in which one cannot favor himself or his customers who offer greater return for such favors above others are weak and relatively insignificant determinants of behavior.[10]

A. *The Basic Plans*

Through dealing with many lawyers who had represented chemical companies during the shortages of 1974 and 1975, I was aware almost all the large chemical companies had experienced shortages and had allocated many products. I also knew their lawyers had become quite sophisticated about allocations. They had raised a host of interpretative questions concerning section 2-615 and the cases decided under it. For those reasons I started my research with the conception that each company would have a written plan which spelled out the allocation concerning each customer and response to each consideration in intricate detail. My conception could not have been further from the truth. Of the companies interviewed, none had a written allocation plan or a fixed plan concerning its products. Although lawyers had given oral or written advice in every case, most companies had a different and informal plan with respect to each product. Typically, chemical company sales staff are divided according to product line, and

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ville Coke & Iron Co., 56 F. 212 (3d Cir. 1893) (proration doctrine applied in shortage of rail cars to ship coke but court acknowledged supplier's ability to favor certain uses; here, blast furnaces preferred over foundries); Jessup & Moore Paper Co. v. Piper, 133 F. 108 (3d Cir. 1902) (proration doctrine applied in shortage of coal cars); County of Yuba v. Mattoon, 160 Cal. App. 2d 456, 325 P.2d 162 (1958) (prorate crop among lessors when quantity limited by government order); Akins v. Riverbank Canning Co., 80 Cal. App. 2d 868, 183 P.2d 86 (1947) (prorate tomato boxes among growers); Amsden Lumber Co. v. Stanton, 132 Kan. 91, 294 P. 853 (1931) (proration doctrine applied in sale of cement); Ranney-Davis Mercantile Co. v. Shawano Canning Co., 111 Kan. 68, 206 P. 337 (1922) (prorate bean and beet crops diminshed by poor weather); Davison Chemical Co. v. Baugh Chemical Co., 133 Md. 203, 104 A. 404 (1918) (proration doctrine applied but court found supplier had diverted sulphur supply to higher priced noncontract uses); Garfield & Proctor Coal Co. v. Pennsylvania Coal & Coke Co., 199 Mass. 22, 84 N.E. 1020 (1908) (purchaser of mines could not prorate among mine's old customers); Oakman v. Boyce, 100 Mass. 477 (1868) (early recognition of reasonableness of pro rata allocation applied to sale of coal); Clay Grocery Co. v. Kenyon Canning Corp., 198 Minn. 533, 270 N.W. 590 (1936) (prorate corn crop diminished by drought). *See also* White, *supra* note 6, at 504-14.

9. U.C.C. § 2-615, Comment 11 (1972).

10. One is always free to violate his contract provided he is prepared to suffer the consequences. The fact the courts are unlikely to impose consequences in this context suggests the moral force of the law is not very strong. Of course it is also possible the law here is inconsistent with the mores and understanding of the parties. If the buyer believes in times of shortage I will favor myself first, and if we regard that as an implicit term of the contract, I have committed only a technical violation of the contract by doing so.

specific corporate employees are responsible for sale and distribution of specific products. The contractual and practical relations with the buyers of various products differ from product to product and from company to company. For example, one company might sell its entire output of product A to a single buyer. Another might have hundreds of thousands of individual buyers for a specific product. A company might be a sole supplier to a particular buyer or it might be but one among ten or twenty suppliers to a particular buyer. The buyer might have economically viable substitutes for the particular product or he might have no substitutes. For all these reasons the allocation plans from product to product and company to company vary according to the circumstances.

Nevertheless, it soon became clear that the predominant mode of allocation was a specific form of pro rata allocation. That mode was to allocate on a pro rata basis in accordance with actual purchases over an historic period. If buyer A had purchased one million pounds last year and buyer B had purchased 500,000 pounds last year, buyer A would receive twice as large an allocation this year as buyer B. This would be true even though the contracts of buyers A and B contain identical quantity terms. The conventional practice in the chemical industry is to write contracts that contain minima and maxima. The practice is for the seller to urge the buyer to take as much of the product as he will but not to insist that the buyer take even the minimum amount in his contract. This convention is so deeply imbedded that a contract which would appear normal to a sales lawyer, namely one with a specific quantity in which both the buyer and the seller expect to deliver that quantity, is treated as a variant in the chemical industry. That variant is called a "take or pay" contract, a name that sets it off from the usual contract in which the seller agrees to deliver up to a certain amount, but in which he does not insist that the buyer take the minimum amount. Partly because the quantities specified in the contracts bore no necessary relationship to the amount the purchaser had actually taken and paid for in the historic period, or even any necessary relationship to the buyer's current intention, most sellers allocated not according to contract amount but according to historic "take."

Allocating according to historic take has another, and not incidental, consequence. It allows one to allocate to his contract customers and also to his "spot" customers who have no contracts. By hypothesis, in time of shortage, the spot prices will be higher than the prices in long term contracts; for that reason it will be in the short run interest of the seller to sell as large a percentage of his product to spot buyers as he can without offending his contract buyers. The allocation according to historic take and not by contract amounts tends to maximize the sellers' short run profits.

Two respondents allocated according to contract amount with respect to one product each. In one case the seller had long term "take or pay" contracts and believed that it was in its long term interest to allocate 100% to the buyers under those contracts even if they would not have been legally required to do so. In the other case, the seller allocated according to the contract amount as a reward to the persons who had signed those contracts. The contracts had been signed at a time when the seller wished to expand its facilities and needed large, apparently specific, contracts in order to acquire financing for that expansion. When the subsequent shortage came, it felt morally obligated to those who had signed contracts containing large quantities. It felt free, conceivably even anxious, to give a smaller share to those who had refused to sign such contracts.

A third pro rata variation was to prorate according to geographic regions. If a company which sold its products nationwide had divided the country into four geographic regions and concluded its future lay in the southwest where prices were higher, it might choose to allocate pro rata according to divisions and not according to historic take. Such an allocation might allow it to achieve both larger short run profits and greater long run returns than a pure pro rata allocation based upon the purchases of a prior year. At least one respondent allocated one product according to regions.

Before one considers the multitude of variations from pro rata distribution, he should consider the variations that are possible under the "pro rata" roof. Each of the three pro rata allocations described above has the possibility of producing radically different distributions of particular products. If it is within the power of the seller under section 2-615 to make such choices, he has enormous discretion even within the pro rata rubric.

B. *Contract Clauses*

As one might expect, the form contracts of all the respondents contained terms that dealt with allocation. Some were no more than an attempt to restate section 2-615. Others were clever and intricate attempts to give the seller greater discretion in allocation, often in language that might not disclose to the buyer the full scope of the sellers' intention. The most common allocation clause was one that either simply incorporated section 2-615 as a standard, or incorporated those standards with a specific provision concerning some idiosyncratic aspect of the seller's business or experience. Rarely did the respondents refer to the rights specified in their contracts. Indeed, it was unclear whether any of the lay respondents appreciated that their own contracts dealt with allocation.

As part of the study, I examined approximately thirty chemical industry contracts from more than seventeen companies. All but three of the contracts contained an allocation clause of some sort. Fifteen of the contracts called for an allocation that was "fair and equitable," "fair," "equitable," or "fair and practical." The following is an example:

> If . . . Seller is unable to supply the total demands for any material specified in this Agreement, Seller shall have the right to allocate its available supply among its customers and its departments and divisions in a fair and equitable manner. In no event shall Seller be obligated to purchase material from others in order to enable it to deliver material to Buyer hereunder.

The allocation clause in these contracts would give the seller the same rights he would enjoy under section 2-615(b).[11] Sixteen allocation provisions included the seller itself among its customers and "its own internal needs"; "its own requirements and the requirements of its divisions, subsidiaries and affiliates"; and "including seller for its own manufacturing operations of its subsidiaries and affiliates." These clauses merely exercise an option that section 2-615(b) offers to a seller.[12] By enlarging the pool, however, they diminish each pool member's pro rata share.

Ten contracts from four companies contained a clause that purported to leave the seller free to allocate upstream products in any way it saw fit. If a seller could use natural gas to produce any of three saleable products; methanol, ammonia, or liquid hydrogen, such a clause would enable the seller to devote its available supply of natural gas to the production of the most profitable of the three, even to the exclusion of the other two. One such clause is unusually explicit:

> During any period of raw material shortage, seller and producer reserve the right in their sole judgment to determine what products shall be manufactured of available materials. The curtailment or discontinuance of manufacture and sale of products pursuant to such determination shall be excused. . . .

11. U.C.C. § 2-615(b) directs the seller to allocate "in any manner which is fair and reasonable." *Id.* Seven contracts introduced a subjective standard of fairness, reasonableness or equity; *e.g.*, the seller should allocate "in any manner which in the opinion of the seller, is fair and reasonable." In one contract the "fair and practical" allocation was left to the seller's discretion.

12. A seller "may at his option include regular customers not then under contract as well as his own requirements for further manufacture." U.C.C. § 2-615(b). The section does not mention a vertically integrated seller without further manufacturing requirements but with internal needs for processed goods or with sales contracts for raw materials. Some contract provisions explicitly include these uses, *e.g.*,

> Seller may . . . allocate its supply of such raw material among its various uses thereof (*e.g.*, manufacturing and sales) in such manner as Seller deems practicable and allocate its supply of such goods among such various uses thereof and among its contract and non-contract customers in any manner which, in the opinion of the seller, is fair and reasonable.

Internal memoranda from the company that employed the following clause indicated that its lawyers thought they, too, had reserved complete freedom to allocate raw materials to any of its various product streams.[13] The clause is as follows:

> Seller may . . . first satisfy its own requirements and requirements of its divisions, subsidiaries and affiliates for such material and for the performance of supply contracts for such materials and will then allocate all goods produced among its customers, its own requirements and the requirements of its divisions, subsidiaries and affiliates in a manner and amount that is fair and reasonable.

A seller's retained right to divert all available raw materials to the most profitable of several products would affect pro rata allocation of the various products. A buyer of methanol is faced with a difficult argument when it has contractually agreed that its supplier may discontinue methanol production by devoting all available natural gas to the production of ammonia or liquid hydrogen.

Two contracts purported to give the seller the right to allocate in any manner it deemed proper. The following is an example of such a clause:

> If by reason of any such event or cause, the quantities of the materials covered hereby, or of any materials used in the production thereof, reasonably available to SELLER shall be less than its total need for its own use and for sale, SELLER may allocate its available supply of any such materials among its existing or prospective purchasers and/or its own departments, divisions and subsidiaries in such manner as SELLER deems proper, without thereby incurring liability for failure to perform this contract.

The draftsman of this clause indicated it would give the seller the right to allocate in any manner he pleased without regard to prior purchases or to any pro rata scheme. One wonders whether a court would agree. Might a court read the clause as limited by "good faith" or "fairness"? If so, the clause might produce the same result as section 2-615.

Some of the thirty contracts appear to have been individually negotiated by the parties. These differ substantially from the form contracts drafted by the sellers' lawyers; in some cases the buyer appears to have been in the stronger bargaining position. One contract contained an elaborate formula to be used in determining the buyer's allocation in case of a shortage;[14] others contained a "most favored nation"

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13. A memo from the general counsel reads in part:

> [I]f a shortage occurs we retain complete freedom to allocate raw materials (i) to our affiliates and (ii) to our various product streams before we have to allocate any to make the contracted product. However, once we do make a product, we must then allocate it fairly among all our customers including our affiliates and internal uses.

14. In the event of a shortage of product for any reason during the period of such shortage as specified by Seller in its reasonable judgment ("Allocation Period"), Seller agrees to allocate supply to Buyer using the following formula:

clause.[15] In two cases, the buyers placed limits on the seller's ability to divert raw materials upstream.[16] One contract provided for a tolling arrangement at the buyer's option.[17] Two others apparently attempted to give the buyer absolute priority over all other purchasers from the seller.[18] *Quaere* whether such an absolute priority is valid against a third party without notice.

Some of the clauses show considerable lawyer imagination and effort. Clearly some of them were specifically negotiated for particular transactions. One would assume in such cases not only the lawyer but also the contract administrators would know of such clauses and would honor them. For the most part, the boilerplate clauses added little to the buyer's or seller's rights under section 2-615. No lay respondent referred to a contract clause in answer to any of my questions about his rights or behavior. One lawyer respondent questioned how one would determine whether a "most favored nation" clause was being honored by another party. There had been some discussion among the company representatives about the efficacy of such a clause in the face of

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ALLOCATION FORMULA

$$\frac{A}{B} \times \frac{C}{D} \times E$$

where . . .

A. is Seller's available amount of Product for current Allocation Month.

B. is Average monthly amount of Product Delivered to all customers of Seller (including Buyer and Seller's captive consumption) during 12 months immediately preceding Allocation Period.

C. is Annual Quantity for current Calendar Year.

D. is Annual Quantity for last Calendar Year.

E. is Average monthly amount of Product Delivered to Buyer during 12 months immediately preceding Allocation Period.

For purposes of implementing this formula, Seller's sole obligation is to provide the resultant ratio of A to B, and not the actual figures for A and B.

15. In the event a shortage of relevant supplies or raw materials occurs which effects _____'s ability to produce ____ under this agreement, so that an allocation of manufacturing capacity or sales of product is necessary, no other customer of —— shall be given a priority higher than —— —— and ————'s allocated amount shall be at least directly proportionate to the availability of relevant raw materials.

16. An example of such a clause is as follows:

> In the event of shortage of supplies or raw materials or the occurrence of any other event or force majeure . . . seller agrees that if the production of product at the plant is curtailed that seller will exercise reasonable efforts to limit the curtailment of the production of product by an amount which, on a proportional basis, does not exceed the percentage curtailment of other products produced on the equipment and through the same process.

17. In the event of any shortage of supplies or raw materials or the occurrence of any other event of force majeure . . . Seller agrees that if the production of Product at the Plant is curtailed that Seller will exercise reasonable efforts to limit the curtailment of the production of Product by an amount which, on a proportional basis, does not exceed the percentage curtailment of other products produced on the equipment and through the same process.

18. Notwithstanding any provision contained in this section [concerning pro rata allocation] to the contrary, if during the first contract year the aforesaid shortage results from [supplier's] inability to deliver at least 25 million pounds of Amines produced in the New Plant, [buyer] shall have the right to purchase a total of 25 million pounds of Amines pursuant to this Agreement, subject nevertheless to a Force Majeure situation which affects [supplier's] ability to deliver Amines produced in Existing Plants.

the refusal of a seller to allow buyers' auditors to examine the seller's books. Although some skillful effort by lawyers was invested in these clauses, I saw little to suggest the contract administrators knew about or relied upon them in making their allocation decisions.

C. *Justifiable Deviations from Pro Rata Distributions*

Although a pro rata distribution method was the norm for almost all products in all companies, every company deviated from its pro rata model in many ways. Consider first the deviations which are reasoned and clearly justifiable as "fair and reasonable" under section 2-615. A common case in which seller gave more than a pro rata share to buyer was that involving "defense rated" orders under which federal law would call for a preference to a particular buyer.[19] Several companies reported such orders and granted such buyers more than a pro rata distribution.

A second area that would certainly be regarded as a permissible deviation from pro rata under a fair and reasonable distribution system is one to help a buyer who would otherwise suffer extraordinary economic injury or the social cost would be great if the seller insisted upon a pro rata distribution method. Several respondents reported they granted more than a pro rata share to certain buyers who would suffer severe economic consequences if they did not get that share. For example, one company granted more than the pro rata share of vitamins to an animal food manufacturer who was halfway through a six year cycle to qualify the animal food under some federal agency standards. Had they cut off their distribution, the company would have had to start over and would have lost the several years that had already passed in the six year cycle. Similarly, one company reported it gave more than a pro rata distribution of chlorine to a municipality that used the chlorine to purify its water. If one assumes the seller in such cases did not make an added increment of profit by favoring the municipality or the animal food company, such a distribution would be regarded as fair and reasonable.

In some cases, the buyers' purchases during the historic period under consideration had been abnormally low because of a plant shutdown or for similar reasons. In such cases the seller allocated more than a pro rata share to such buyers in recognition of the fact those buyers had an equal claim with those who had been in operation in the historic period.[20]

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19. *See* 10 C.F.R. §§ 211.26, 211.103, 221 (1980) which accorded priority to Department of Defense delivery orders for crude oil or petroleum products when orders were given a priority rating by the ERA Administrator.

20. Two cases decided under U.C.C. § 2-615 recognize the seller's ability to make adjustments to a pro rata scheme to accomodate unusual circumstances affecting the buyer. *See* In-

A final justifiable deviation from pro rata occurred when a particular product was never thought to be a part of the pool for distribution. For example, one of the companies traditionally entered into long term contracts with specific buyers under which it would build plants adjacent to the buyers' facilities. The contract provided that the entire output of the new plant would be dedicated to the buyers' adjacent manufacturing plant. The seller would then take the contract to a financial agency for use in procuring financing for the construction of the plant. In many cases the product was delivered through a pipeline "over the fence." In such circumstances neither the buyer, the seller, nor any other buyer of that particular product could have a legitimate expectation that any of that product at any time, whether in short or long supply, would go to third parties. During a shortage no reasonable expectations would be injured if the entire output of such a plant were devoted to the traditional buyer.

Because there is a better opportunity for deviousness, a similar allocation where the seller is also the buyer is more questionable. Assume, for example, that a seller asserts he has always used the entire output of plant X internally and thus in times of shortage he has no obligation to allocate the output of plant X. Are we to treat the seller in that context differently than the seller who has made a long term contract and built a plant adjacent to a buyer's plant? Put that way, the answer would seem to be no. However, since there is no external restraint and presumably in many cases no external evidence such as a long term contract to show the practice and commitment, the courts should be more hesitant to accept the argument as a reasoned deviation from pro rata distribution in the latter case than in the former where there is an external buyer.

D. *Unjustifiable Deviations from Pro Rata*

The inarticulate premise of section 2-615 is that a seller should not be free in time of shortage to disregard his long term commitments and favor short term buyers who will pay higher prices. Although it is clear

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termar, Inc. v. Atlantic Richfield Co., 364 F. Supp. 82 (E.D. Pa. 1973); Terry v. Atlantic Richfield Co., 72 Cal. App. 3d 962, 140 Cal. Rptr. 510 (1977). In each case, gasoline station operators challenged Atlantic Richfield's allocation scheme. The Pennsylvania scheme generally limited retailers to 104% of gasoline supplied during the corresponding calendar month one year earlier, in 1972, but made exceptions in circumstances involving "the lack of a 1972 sales history or the occurrence of a material intervening event." 364 F. Supp. at 82. The federal district court opinion provides additional information about Atlantic Richfield's method of handling unusual circumstances:

> In the event a base month is determined to have been adversely affected by a natural and non-recurring event (e.g., traffic disruption, reconstruction, temporary closure, etc.), Region or Zone Managers may approve an alternate basis which shall be an average of the nearest preceding and successive full month on each side of the period of interruption.

Id. at 91. The federal court refused to enjoin Atlantic Richfield's allocation procedure. The California court affirmed a summary judgment for Atlantic Richfield.

the seller may treat himself as a customer, section 2-615 forbids giving himself an additional, unjustified share. Rarely could one justify the addition of new customers under section 2-615 in time of shortage. Discussions with chemical company lawyers, before and during the interviewing process, disclosed that they were well aware of those problems. The written materials furnished by some lawyers indicates they were careful to point out those difficulties to their sellers. Nevertheless, I received a surprising number of admissions that sellers had engaged in non-pro rata distributions which almost certainly were in violation of section 2-615. In two cases, these admissions were made in the presence of company lawyers who were surprised and obviously discomfited by the admissions.

In the remainder of this article I propose to focus on those deviations not because I regard them as particularly evil or interesting in their own right, but because they will disclose something about the power of the law to control behavior in a corporate organization. When one conforms to his contractual and statutory obligations, an observer can never tell whether he did so because of those obligations or for some other motive. When one deviates from those obligations, at minimum we know those obligations were not powerful enough to outweigh the reasons for deviation. Thus it is only in those cases that we can hope to learn something about the power of the law to control behavior in this context.

One deviation from pro rata allocation which was widely practiced, probably in violation of section 2-615, was the diversion of an upstream product. Assume for example, a seller uses natural gas to produce products A and B, and that in normal times he uses 50% of his natural gas to produce A and 50% to produce B. Assume also that in time of shortage the seller will make much more by producing B than A. May he then allocate a larger share of his natural gas to produce B, thus maximizing his profits? By doing so he expands the pie to be shared by the buyers of B and shrinks the pie to be shared by the buyers of A. Several respondents reported they routinely engaged in such allocations. Some of them believed these allocations to be justified and not controlled by section 2-615. They concluded their only obligation was to make a fair and reasonable allocation of the amount of A or B manufactured.

Surely this is too narrow a view of section 2-615. Unless the buyers of A knew of and explicitly or implicitly agreed to the upstream diversion, I think a court would not find such a diversion to be justified under section 2-615. One of the respondents reported he thought most buyers failed to understand the possibility of upstream diversion. On the other hand, some sellers included a contract term that authorized such upstream diversion.[21]

Second, most of the respondents conceded they granted more than a pro rata share to internal uses. As indicated above, in some cases such deviations would be justified but it seems likely that most were not. One respondent stated he allocated only after he had satisfied his own needs. He concluded his obligation was to allocate only that part left over after his company had been satisfied. Purchasing managers interviewed were unanimous in their belief the sellers satisfied their internal demands before they commenced allocation. The representative of one company was remarkably candid: "We sure as hell are not going to short our own plant." To favor oneself is, as he put it, "the strength of a backward integrated company." Moreover, he indicated that next year he might be working for the president of the division he had shorted this year. The implication of his remark was that one's corporate career might well be inhibited by having granted less than the full amount to a corporate superior. Whether the internal use of more than a pro rata share was a *de minimus* share of a particular product or a significant share, I cannot say. I did not inspect the books, and the respondents gave me no quantities.

A third deviation from pro rata distribution which was obviously in violation of section 2-615 was sales to new customers. Two of the respondents explicitly and one implicitly stated they took on new customers in the time of shortage. Except in extraordinary circumstances, it would be impossible to justify the addition of new customers under section 2-615 during a shortage. The rationale for such action was purely economic. As one respondent put it, one should have a right to "salt the market" because times of shortage were when one "added to his market share." He indicated they might serve a new customer where in prior times they "never got beyond the lobby." Such motivation is understandable, but it is not the kind of motivation the cases or the statute would recognize as reasonable and justified.

Finally, all the respondents admitted granting more than a pro rata share to certain buyers for reasons which probably could not be defended under section 2-615. For example, two companies acknowledged they granted greater than pro rata shares to particularly good customers. One buyer indicated that by buying a product which was in long supply and one he did not particularly need, he was able to get more than a pro rata share of the product. He indicated the products were not related but he was led to understand he could not buy a signif-

21. For example, "During any period of raw material shortage, seller and producer reserve the right in their sole judgment to determine what products shall be manufactured of available materials."

icant quantity of the product in short supply without also buying a comparable quantity in long supply.

Most companies reported that they "swapped," *i.e.,* engaged in barter transactions. Although no respondent stated it got an additional share by swapping, it is hard to conceive a reason for swapping except to gain an additional share. Barter transactions are cumbersome and are the rare exception in a modern economy. The only justification for engaging in such transactions is the thought that by granting another person a product in short supply, one gives him a higher price and thus encourages him to return the favor in the form of a disproportionate share of his shortage product. It is my hypothesis the swaps were stimulated by an interest in gaining more than a pro rata share of a particular seller's distribution, and that in fact they were executed principally for that purpose.

By comparing the various buyers' and sellers' allocation behavior with the law and by examining sellers' motives one can attempt to measure the influence of section 2-615 and contract obligations on these particular sellers. Let us turn to that task.

III. THE LESSONS

What can one learn from the foregoing? It seems certain many of the sellers failed to conform to their contractual and statutory obligations. Had all the facts been known and brought to the attention of a court many sellers would have had to pay at least nominal damages. Why was the law insufficient to the task? By analyzing the foregoing rules of law and the behavior of the sellers, one can demonstrate that the rules of law cast only a pale light upon the landscape of commercial contract administration, and that that light is insufficient to hold at bay a variety of wolves and harpies who threaten and beckon to the typical contract administrator.

First, one must understand why the law's power is so slight. To begin with, the law is vague. Section 2-615 says only that one must allocate in a fair and reasonable manner. When one applies that exhortation to the complex and varied fact patterns seen even in a single industry, the difficulty of stating certain rules becomes apparent. Who can say with confidence, for example, that the allocation of an upstream product such as natural gas to diminish the downstream product is an unreasonable or irrational allocation method and in violation of section 2-615? One will search in vain for cases on that point. Even if one assumes it was done to maximize the sellers' profits in apparent violation of the policy of section 2-615, he might justify such an allocation on the basis that everyone in the chemical trade expects such a thing to be done and thus it is not a violation of any buyer's legitimate expectations. At the outset, vagueness of the law, combined with the complexity of the fact patterns, means even some who are intelligent, diligent, and well meaning will be mistaken about the law's commands in a variety of circumstances.

Because the law's command must be executed not by lawyers, but ultimately by lay corporate agents, the problem is compounded. I doubt any of the lay respondents had read even a single case concerning allocation. Few of them knew of the existence of section 2-615 and hardly more than a few had any familiarity with the Code. Thus, each layman had to depend upon his lawyer to apply the law to the particular facts and give direction.

A comparison of the ways in which companies went about that task is informative. One company conducted a slide show in which a lawyer presented a text together with a variety of slides entitled "Can We Tilt?". In other companies the lawyers gave written memoranda to particular persons in answer to specific questions. Nearly all the lawyers had given oral advice to various sales representatives. It should be clear if lawyers are simply responding to questions of the lay seller, the seller has only a small chance of discovering how the law would apply in his particular case. By hypothesis the layman is ignorant of the law. That ignorance alone may foreclose him from asking for the necessary legal assistance. Thus the light of the law, already faint, must pass through a second filter. The lay actor, a corporate seller, must appreciate his ignorance, seek advice, and apply that advice to his own complex facts.

A third filter is a function of the way in which information about legal responsibilities is transmitted within a corporate organization. Without exception, the lawyers are staff personnel, not the supervisors of those who make the selling decisions. Lawyers are not in the operational chain of command; rather, they are likely to come from "headquarters," render advice and return to headquarters. Only in the remotest sense do their careers depend upon the profitability of the various divisions of the company. The layman in charge of contract administration may listen respectfully to the lawyer's description of the law, but he will listen even more carefully to his supervisor's instruction about profitability, sales, and performance. The point was put nicely by a representative in one company when he asked how one could expect him to "short" a person who was the president of another division for which he might be working in the next year. One suspects even when the law shines brightly from the lawyer, that brilliance is overpowered by a greater light from the superior. The superior may conclude the lawyer's advice conflicts with his division's interest. He may find it inviting to seize upon any equivocation in the lawyer's directive or convenient to distort that advice to conform to his conception of his economic interest.

For these three reasons, as well as others, the law's power is significantly diminished by the time it reaches the line contract administrator. Its meaning is uncertain as it is applied to complex facts. Its meaning may be diluted and distorted by its inefficient transmission from the lawyer to the layman. Its power is further diminished because the one transmitting does not supervise the decision maker.

For the purpose of the foregoing factors we have assumed a person, who if informed, was generally willing to comply with the law. What of those who are not willing to comply with it and see their economic interests so thoroughly in conflict with the law that they do not wish to follow it? It is for those that we have sanctions, injunctions, orders for specific performance, consequential, and other damages. Doubtless in some circumstances the prospect of such sanctions has an important impact upon parties to a contract. Consider three reasons which demonstrate why that is almost certainly not true in the chemical industry.

First, the complexity associated with the performance of the typical chemical contract renders it unlikely any party will find out or be able to prove that another has not complied with the allocation rules. Based on the respondent's reports, I discovered various sellers favored themselves, particular customers, or added new customers. Only by happenstance or through very expensive investigation could one ferret out such information from an uncooperative seller. Consider a large chemical company that sells hundreds of products to thousands of buyers. Remember that section 2-615 does not demand all sales be on a pro rata basis, only that they be fair and reasonable. How then does one prove that as a recipient of product X, he has received less than his share because there has been an unfair and unreasonable allocation of product X to another person? Absent a gross deviation from a pro rata allocation, one would have difficulty proving such distribution. Only the prospect of a large pay-off would justify the expense necessary to prove such a fact.

Second, the relationship between the buyers and sellers in the chemical industry mitigates against lawsuits. None of the respondents reported any significant lawsuits. Several had received threats of suits; one or two had been sued in minor matters, but none had been involved in major litigation related to contract claims on shortage products. Part of the reason is the cost one incurs in undertaking such litigation. If a seller allocates some part of the product and one is able to continue production with that allocation, albeit less efficiently and less profitably than if he received a larger amount, he runs the risk of forfeiting that share by commencing a lawsuit. Not only does one run the risk of forfeiting that amount, he also risks interfering with tens or perhaps dozens of sales and purchases of other products from and to the other potential litigant. Because chemical companies buy from and sell to other chemical companies on a large scale basis, the disruption of all those transactions may well be more expensive than the expected pay-off arising from a lawsuit.

The final and related point which inhibits litigation is the kind of injury suffered by one who is receiving a modest but unjustifiably reduced allocation. By hypothesis that party is not suffering the kind of catastrophic injuries which occur when one cancels a long term supply contract like Westinghouse did with its uranium contracts, or when a large and expensive product fails and causes millions of dollars of economic loss. Rather, the plaintiff is likely to suffer some significant but less than catastrophic loss in profits. Thus, when he makes the calculation described in the foregoing paragraph and weighs the expected return of a lawsuit against the likely disruption of the business relationship, he will probably decide against the lawsuit.

Yet this is only part of the puzzle. The law is weak not only because it is poorly transmitted through various filters to reach our hypothetical contract administrator, but also because its sanctions are distant and unlikely to be suffered. Its weakness is magnified because it must compete with a series of conflicting motivations. The corporate employee must serve his company's selfish interests; he must also serve his own selfish interests. That the legal obligation will conflict with the selfish interest is commonplace; presumably that is why we have contract sanctions. My study shows the motivation of the contract administrator is more complex than one might think.

The contract administrator has to protect his own interests. Even if it might be in the long range interest of his company to follow the law and even if its profits might be maximized by doing so, he may choose to violate the rules of section 2-615. He might, for example, allocate to an internal use because he sees such a diversion to be in his personal interest. He may perceive that such allocation will endear him to one with power over his advancement within the company.[22]

Also important are the contract administrators' relationships with persons associated with the buying companies. Contract administrators repeatedly reported that they gained more than they otherwise would have, or expected to receive additional orders after the shortage was

22. Ideally of course, a company should not be set up so that personal goals of the employees conflict with the corporate goals and cause them to do things that are not in the interest of the corporation. I doubt such an ideal corporation exists, and certainly in this case it is easy to hypothesize a situation in which an employee will be influenced by his interest in personal advancement to violate the rules of § 2-615.

over because of their particular relationship with persons in the buying or selling departments of other companies. They reported these benefits would last only as long as the same personnel were in those organizations and they had varying opinions about how long such benefits were likely to survive a shortage period. It was obvious their personal and moral obligations to persons in those companies would influence their pattern of purchases both during and after the shortage.[23]

IV. CONCLUSION

After one has examined barriers to the law's reach and has observed the manifold pressures to escape even its weakened grasp, one wonders if the law has any effect at all on contract administration in a shortage. The respondents confessed a variety of behavior that was in violation of section 2-615 and the cases. Yet none of them reported any significant legal challenge from a party who might have been injured by their deviation from the law's dictates.

Even when the parties conformed to the rules of section 2-615, their conformity may not have been dictated by the rules of law but by intelligent self interest. Pro rata allocation based on historic take is probably a sensible economic compromise between one's long and short term interests. I saw no evidence such an allocation method was adopted because the law of contracts called for it.

If the law was incapable of shaping these contract administrators' behavior, are we to conclude it is truly an artifact of twentieth century commercial life, an external substance of no significance to the economic life of these companies? The data falls far short of proving that, yet it does not conflict with that idea. I found considerable evidence that lawyers were diligent in attempting to interpret the law, were careful to advise their clients, but found little evidence there was any significant change in any company's behavior in response to the law.

If one assumes for the moment that my hypothesis is correct; namely, that the law is in fact irrelevant in determining the behavior of chemical companies during allocations, what can one conclude about commercial contract law in other areas? Are we to conclude that buy-

23. It brings me to a question with which I concluded a number of my interviews, namely, "Why do you sign contracts at all?" A norm in the chemical industry is to put maximum and minimum quantities in a contract and for neither party to insist upon purchase of either the maximum or the minimum. By 1977, contracts fixed prices only for a very short period, if at all, by tying them to some outside measure. Thus the contract failed to do two of the things a law student would traditionally expect a contract to do, set the important terms of price and quantity. Sales representatives did not have very good answers to those questions. Some reported the specifications of the product were important and they wished those to be written into the contract. Others pointed out the contract quantities tended at least to be related to the amount of the take, and thus were useful for planning considerations. Some thought the boilerplate on the back of the contract might be useful in a warranty dispute. The answers on the whole however were not persuasive.

ers' and sellers' behavior in contract formation, in contract modification, in determining whether to take actions that might be regarded as breach of contract are all taken in ignorance of or without regard for the law? Of course that is not true. Obviously when there are millions of dollars at stake, when the risks and costs are very high, any sensible businessman will consult his lawyer. However, my findings are compatible with the idea that a large part of the behavior a lawyer might conceive as in response to the dictates of the law is in fact taken in ignorance or disregard of it.

How should one shape his behavior in response to that learning? For the house counsel it will confirm his darkest fears about his client's disregard for his advice. It will demand a search for new ways to make one's client listen and conform. For the legislator and judge, it will call for more humility. The lawmakers must be more willing to make the law conform to the sensible practices of business and to accept the fact that the law is incapable of changing those practices except at great cost. For the teacher of contracts, it means acceptance of a diminished role. If his students are truly to understand contracting parties' behavior perhaps he must integrate his contract teaching more fully with the conflicting currents of commercial life.

APPENDIX

ALLOCATION INTERVIEW CHECKLIST

I. Allocation Experience
1. Did you ever allocate in a situation of commercial impracticability?
2. If so, on an ad hoc basis or pursuant to a plan?
3. What gave rise to the allocation?
4. Have you ever thought about or planned for allocation but never had occasion to implement?
5. What products? Different plan for each product?

II. Allocation Plan—Basis for and Built-in Exceptions
1. Has allocation ever been a subject of your contract bargaining? What result?
2. Do you have a term in your form contract that purports to give you greater allocation rights than you would have without such a term?
3. What legal constraints were considered in formulating an allocation plan?
   (a) UCC §§ 2-615, 2-616
   (b) Antitrust laws
   (c) Government priorities
   (d) Contract liability
   (e) Other
4. Other factors or goals considered
   (a) Ethical limitations
   (b) Profit maximization
   (c) Maintaining customer relations
   (d) Public relations
   (e) Government relations—minimizing intervention
   (f) Other
5. Did you reject any methods as illegal or of questionable legality?
6. Is your allocation (a) pro rata on an historical period or (b) pro rata on present contracts or (c) other? (*i.e.,* how do you determine the proration)?
7. Do you allocate the entire supply of the company or do you make different allocations from different sources? (whether those sources be purchasers or plants)
8. If you allocated on the basis of sales during a historical period, (a) how did you choose that period? (b) did you make any exceptions and if so, on what basis? *(e.g.),* for those who made no purchases during that period or who normally

purchased or who made unusually large purchases during that period.)

9. Is there a difference between a shortage in an "upstream product" (which will be used by you to produce a variety of products to be resold) and shortage in a single use product?
10. Are certain uses favored or disfavored?
    (a) As part of the plan or ad hoc
    (b) Defense rated orders
    (c) Socially beneficial (*e.g.*, hospitals)
    (d) Purchase for resale
    (e) Other
11. If you allocated specially to a certain use, did you then subtract such priority allocations from the customer's later regular allocations?
12. Are certain customers favored or disfavored?
    (a) Non-contract "captives" (sister divisions, subsidiaries, and affiliates)
    (b) Non-contract, non-competitors
    (c) Non-contract, competitors
    (d) Any consideration of customer's economic or other hardships (*e.g.*, impending insolvency or ability to convert to other, available good?)
13. How might one aid a favored customer? *E.g.*, "borrowing ahead," barter of scarce goods, tolling?
14. Have you ever taken on new customers when you are allocating to others? At a different price than the contract customers? At a high enough price to bring supply and demand into equilibrium?
15. Do you distinguish among spot buyers? (some in and some not in plan?)
16. In a shortage situation did you treat the regular spot customers the same as or different from contract customers? Do you feel legally obliged to give them the same treatment?
17. Are customers dealt with in classes? How do you define classes of customers? (by their end use of the product or by the product consumption of the seller?)
18. If you have classes of customers for a single product, (*i.e.*, the users of the product itself and the users of the derivative that is purchased from you after some processing) how do you allocate between those two classes?
19. Did you ever lease a portion of your plant or use it to process somebody else's raw material when you could not obtain the product on your own? Did you get a share of the output and if so how did you use that output?

20. Do customers have advance notice by contract clause or otherwise of the possibility of allocation and the method to be used? In a form contract?
21. How have you notified customers of a shortage?
22. Have you attempted to arrive at agreements with customers before unilateral imposition of an allocation? Successfully?
23. In your allocation arrangements, did you hold back a certain percentage to handle contingencies or particularly insistent and disruptive customers?
24. To what extent do you believe that operating personnel for whatever reason deviated from an agreed allocation plan, either out of ignorance, to satisfy a particularly insistent customer or for other reasons?
25. Have you formerly used but improved upon a method?

III. Profit Maximization
1. Under what circumstances do you believe you can justify the greater allocation to an end product use that has a higher profit margin than to another product use?
2. To a customer who is paying a higher price for the same product than another customer? (if you have allocated, has it increased your profit on the allocated item?)
3. In the case, if any, in which you deviated from your pro rata scheme, did it ultimately prove to be in your economic interest to do so? (*i.e.,* was the profit margin higher on those sales than on the average to the other allocatees?)

IV. Challenges to Allocation
1. Has there ever been a challenge to your proposed or actual allocation?
2. Threat of or actual litigation? Result?
3. Have you anticipated litigation or prepared defenses?

V. Receiving End Experiences as an "Allocatee"
1. Have you ever been on the receiving end of an allocation?
2. Did you bargain about the allocation?
3. What were your arguments?
4. Was it a form contract?
5. Were you ever pressured to accept less than a full order?
6. Were you involved in litigation as a buyer?
7. Reactions in general

VI. Law Reform
1. How are the UCC, antitrust laws responsive or not responsive to the problems involved in allocation?
2. How could the law in this area be improved?